CANADA

NATIONAL ENERGY BOARD

REASONS FOR DECISION

On Review of its Decision
on Phase I of the Application under Part IV
of the National Energy Board Act
of

Westcoast Transmisson Company Limited

November 1978

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THE APPLICATIONS

By application dated 15 September 1977, Westcoast Transmission Company Limited ("Westcoast" or "the Company") applied to the Board for an order or orders under sections 50 and 53 of the National Energy Board Act ("NEB Act") giving effect to the tolls which Westcoast proposes in the application to charge for gas produced in British Columbia and sold by the Company to its British Columbia and export customers and disallowing any tolls and tariffs presently in effect which are inconsistent with the proposed new tolls and tariffs. Application was also made under section 53(1) of the Petroleum Administration Act ("PAA") for an order or orders amending the existing Special Orders under Part III of the PAA in relation to gas produced in the Province of Alberta and the Yukon and Northwest Territories, to reflect the new cost of transmitting that gas through the Company's pipeline.

By Order No. RH-2-77, the Board set down for hearing the application under Part IV of the NEB Act and directed that the hearing be conducted in three phases

dealing with the issues raised in the Company's application in the following order: firstly, the depreciation and income tax components of the Company's proposed cost of service in Phase I; secondly, the Company's proposed rate base, cost of service and rate of return in Phase II; and, thirdly, rate design and other related tariff matters in Phase III. The Board commenced hearings on Phase I of the application in February 1978, and in May 1978 issued its Decision in respect of the depreciation and income tax components of the cost of service. The conclusions reached in the Phase I Decision may be summarized as follows:

(1) with respect to Westcoast's gathering lines and production extraction plants, the Board accepted the Company's proposal to depreciate these facilities at straight-line rates determined on a unit-of-production basis, at the rates of depreciation set out in Appendix III to the Decision;

(2) with respect to the main transmission plant of the Company, the Board directed that Westcoast continue to depreciate those assets

at the present rate of 2.3 per cent, subject to certain tentative particular treatment for that component of the main transmission plant to be allocated to the export market;

(3) with respect to income taxes, the Board directed Westcoast to change over to the normalized method of accounting for corporate income taxes and to include in its cost of service income taxes for the current period based on the normalized method;

(4) with respect to deferred income taxes arising from past operations of the Company since 1957, and referred to as "catch-up" taxes, the Board directed that these "catch-up" taxes be recovered in the cost of service of the Company in respect of domestic sales over a 25-year period and in respect of export sales over the remaining life of Licence No. GL-41;

(5) Westcoast was directed to propose a specific method of allocating normalized taxes, "catch-up" taxes and depreciation of its main transmission plant as between its export and domestic business based on certain guidelines contained in the Decision.

As part of that method of allocation, Westcoast was directed to depreciate the portion of its main transmission plant to be allocated to the export market over the remaining life of Licence No. GL-41, which allocation would give rise to a depreciation rate for the export portion of the plant considerably in excess of the 2.3 per cent applicable to the balance of that plant;

(6) with respect to the funds recovered in the cost of service on account of the deferred tax liability, the Board directed that these funds should be deducted from the rate base of Westcoast; and

(7) the specific method of allocating taxes and depreciation to domestic sales and exports within the framework of the guidelines given, and the question of whether the rate of return on equity should reflect any risk associated with the use of funds generated by deferred taxes, were reserved for further consideration in Phase II of the hearing.

In June 1978 four applications were filed with the Board under section 17(1) of the NEB Act for a review of the Phase I Decision. Those applications were filed on behalf of:

(a) the Attorney General of British Columbia,

(b) British Columbia Petroleum Corporation ("BCPC"),

(c) the Council of Forest Industries of British Columbia ("COFI"), and

(d) Cominco Ltd., Consumers Glass Company Limited, Domglas Inc. and Hiram Walker and Sons Ltd.

Basically, these applications sought a review of the following aspects of the Phase I Decision:

(1) the decision of the Board to require Westcoast to change over to the normalized method of accounting for corporate income taxes and to include such taxes in the cost of service;

(2) the decision to require Westcoast to provide for the "catch-up" of deferred income taxes in its cost of service; and

(3) the decision to require Westcoast to propose a specific allocation method for the purpose of a possible allocation of current normalized taxes, "catch-up" taxes and depreciation of its main transmission plant to the export and domestic components of its business, on the basis of the guidelines contained in the Phase I Decision.

On 26 July 1978, the Board heard the submissions of the Applicants for review, and other interested parties, on the issue of whether the Board should undertake a review of the Phase I Decision. Based on the submissions so made, the Board concluded that it should undertake a review pursuant to section 17(1) of the NEB Act of the above aspects of the Phase I Decision. The Board further concluded that the review would proceed on the basis of the record in the original Phase I hearing, and the submissions made at the hearing of 26 July 1978, since it did not appear to the Board that any case had been made for adducing any additional evidence relating to the issues considered in Phase I of the hearing.

REASONS FOR DECISION

On the basis of the submissions made at the hearing of 26 July 1978, the Board has reviewed the Phase I Decision in the Westcoast application upon the following issues:

(1) the change to the normalized method of accounting for corporate income taxes and the inclusion of such taxes, on a current basis, in Westcoast's cost of service;

(2) the inclusion in Westcoast's cost of service of deferred income taxes arising from past timing differences; and

(3) the possible allocation of current normalized taxes, past deferred taxes and depreciation of Westcoast's main transmission plant, between its export and domestic business on the basis of the guidelines set out in the Phase I Decision, including the accelerated depreciation of the portion of the main transmission plant so allocated to the export business.

In conducting this review, the Board has considered the relevant evidence and exhibits adduced in the Phase I hearing, and the written arguments filed by the various parties at the conclusion of that hearing.

The following are the Board's decisions and reasons for decision arising from that review.

THE PHASE I DECISION OF MAY 1978

In the course of the hearing on 26 July 1978 it became apparent that there was some confusion as to the exact effect of the Phase I Decision on two issues. Firstly, the Canadian Petroleum Association raised the question as to whether the Phase I Decision had adopted the unit-of-production method as being appropriate for the depreciation of the main transmission plant of Westcoast. At page 2-14 of the Phase I Reasons for Decision, it was found that straight-line depreciation rates determined on a unit-of-production method, for gathering lines and product extraction plants, as proposed by the Company, were appropriate because those facilities and the reserves supporting them occur in a relatively localized area. With respect to the main transmission plant, it was held at pages 2-15 and 2-16 of the Phase I Reasons for Decision that Westcoast's approach on the unit-of-production method, using a useful life of 21 years based on proven gas reserves in British Columbia, failed to give adequate weight to the possible use of the main transmission system to transport

Mackenzie Delta and other Territories gas, Alaskan gas, and out-of-province gas not included in the Westcoast calculations of service life. It was found that, on the basis of existing estimates of reserves, Westcoast has the capability of serving its domestic customers with gas delivered through its main pipeline for a period in excess of 25 years. Having considered the Phase I Reasons for Decision, the Board is of the view that, in respect of the main transmission plant, that decision requires depreciation to be charged in the cost of service at a rate of 2.3 per cent, based on the straight-line method, except for that portion potentially to be allocated to the export business of Westcoast, for which it appears that an accelerated rate of depreciation might apply. Recognizing that gas might enter the pipeline from other sources, and the absence of any calculation of the amount of the reserves from those other sources which would be dedicated to the Westcoast system, it appears that no other conclusion is possible.

The second aspect of the Phase I Decision over which questions were raised was the degree to which that decision was final in respect of the allocation of depreciation, income taxes and plant, as between the export and domestic business of Westcoast. At page 2-31 of the

Phase I Reasons for Decision, Westcoast was directed to propose a specific method of allocation of income taxes, depreciation and its main transmission plant in accordance with the guidelines set out. It appears from that ruling that the allocation methodology would be the subject of further consideration in Phase II of the hearing. It is, however, clear from the Phase I Decision that the export portion of Westcoast's business was intended to bear fully all costs associated with transporting the gas to the export market, in accordance with the general policies of the Board respecting export prices set out at page 2-11 of the Phase I Reasons for Decision. In any case, the Board will deal with the principle or concept of cost allocation later in these Reasons.

INCOME TAXES

In its application to the Board, Westcoast proposed to change its method of accounting for income taxes from the taxes payable or "flow-through" method to the tax allocation or "normalized" method, and to recover income taxes in its cost of service based upon the latter method. On the basis of the 1977 test year shown in its application, Westcoast seeks to recover in its cost of service $42,294,103 on account of current normalized income taxes. Since 1957, when it commenced operations, the Company has

been accounting for income taxes on the flow-through basis and, as at 31 December 1977, the total income taxes deferred by the Company since 1957 amount to $231,075,356. Westcoast has proposed to provide for the "catch-up" of these past deferred income taxes by recovering them in its cost of service over the period until 31 October 1989, the unexpired portion of the term of Licence No. GL-41. On this basis, the annual amortization in the cost of service on account of past deferred taxes would be $19,527,495. Allowing for certain credits given by the Company, the total amount it seeks to recover in its cost of service, based on the test year figures, is $59,889,993, on account of both current and past deferred income taxes, using the normalized approach.

Under the flow-through method, a company would record as the tax expense in any year the amount of income taxes actually payable in that year. Under the normalized method, the tax expense in any year is based upon accounting income, regardless of whether taxes are actually payable in that year. Accounting income differs from taxable income primarily because of timing differences arising from the use of capital cost allowances which usually exceed booked depreciation taken in the accounts of the company in the earlier years of its operations. Under the normalized approach, the provision for income taxes is based on the

accounting income, as an expense in those years, and the provision for income taxes, therefore, includes taxes that are not required to be paid until some time in the future.

The effect of normalization on non-regulated enterprises is quite different from that on regulated companies. In a non-regulated business, a change from the flow-through to the normalized method of income tax accounting has no effect on gross revenues, but causes earnings to be reduced in the earlier period following the change. In a regulated company, where the regulatory treatment of income taxes is changed from flow-through to normalized income taxes, the effect of normalization is to increase the company's gross revenues in the earlier years, but with no effect upon earnings after taxes, because the provision for taxes payable in the future is included in the current cost of service of the regulated company and thus reflected in its current rates.

The Westcoast application is based upon the cost of service, rate base, rate-of-return approach to toll determination, which is the same basis upon which the Company's cost of service has been determined under the provisions of the agreement of 13 November 1973 between Westcoast and the BCPC ("BCPC Agreement"). This methodology is essentially a cost-based approach by which a cost of

service is determined for a test period and transportation tolls are designed to generate sufficient revenues to recover the total cost of service. This approach necessarily gives rise to the question as to what is the appropriate basis upon which the Board is to recognize various costs for inclusion in the cost of service of a company for rate-making purposes. In dealing with this type of issue, the Board has generally had regard to professional accounting standards, although the Board recognizes that such accounting standards are not binding upon it in any way for rate-making purposes. In the determination of the appropriate components of a regulated company's cost of service, the Board must be and is always guided by the principle of which method of cost recognition is the most appropriate for rate-making purposes. The considerations relevant to that issue vary with the nature of the particular item of expenditure being considered and the overall circumstances surrounding the operations of the particular company being regulated. In the case of Westcoast's cost of service, both as proposed in its application to the Board and as determined under the operation of the BCPC Agreement, there are items in the cost of service which do not constitute actual cash outlays by the Company in the period to which that cost of service relates.

Examples of these are depreciation, insurance, pension costs and taxes.

With respect to Westcoast's proposal as to the appropriate basis for dealing with income tax in its cost of service, the review has taken into account all circumstances which appear to be relevant including previous views of the Board in this matter in the 1975 TransCanada PipeLines Limited case[1] and in the 1977 Interprovincial Pipe Line Limited case, where the Board stated:

> In making its decision on what method of accounting for income taxes the Board will direct the Company to adopt, the Board must take into account a number of factors, including - the capital requirements of the Company - the likelihood of crossover - the need for equity between classes and generations of customers - the need for consistency.[2]

Included in the various items which, in the Board's view, are relevant to this issue, are the opinions of professional accounting bodies regarding the most appropriate treatment of income taxes for accounting and regulatory purposes. As stated earlier, while the Board may take such views into account, the Board is not, of course, bound by them.

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1. TransCanada PipeLines Limited, Phase I, June 1975.

2. Interprovincial Pipe Line Limited, Phase II, December 1977, page 4-36.

1. Accounting Evidence: Normalized v. Flow-Through Tax Accounting and Cost Recognition

Considerable evidence was adduced at the Phase I hearing relating to the recommendations of the accounting profession respecting the two methods of tax accounting and the question of cost recognition. In paragraph 3470.56 of its accounting recommendations dated September 1973, the Canadian Institute of Chartered Accountants ("CICA") states:

> The research committee believes that the general principles of income measurement should be the same in regulated industries as they are in other enterprises and that the income tax allocation basis should have equal relevance. While the opinion was expressed that exemptions can only open the door to the submission of what may be considered equally valid circumstances, the research committee recognized that there may be rare cases where compliance with the recommendations of this section would be inappropriate for the purpose of achieving a proper matching of costs and revenues. Two examples might be:
>
> (a) a company in the regulated utility field under the jurisdiction of an authority which allows as an element of cost in setting rates only the amount of taxes currently payable;
>
> (b) a company whose revenue is determined by long-term contracts under which costs incurred are reimbursed and such costs are defined to include only taxes payable for the period.

It is clear from the above ruling that the CICA would prefer all companies, including regulated utilities, to follow the income tax allocation basis (normalized method). The ruling, however, recognizes that in the case of regulated utilities there can be an exception, either because rates are set so as to include only the amount of taxes currently payable or because a company is under some form of long-term contract. The overall rationale given by the CICA in its recommendation in favor of normalized income tax accounting is the application of the general accounting principle of matching costs and revenues.

From the accounting evidence given at the hearing, it appears that in the case of non-regulated companies, the CICA recognizes the provision for normalized income taxes to be a cost in the period in which such taxes are recorded. Similarly, for a regulated utility, where the regulatory authority permits the inclusion of income taxes on the normalized basis in the rates of a utility, then the accounting profession recognizes income taxes calculated on that basis to be a cost. If, however, such recognition is not accorded by the regulatory authority, then the accounting profession would accept income taxes based on the flow-through method as being the appropriate cost in any period.

In the 1975 TransCanada PipeLines Limited case, the Board considered the effect of the CICA accounting recommendations and of the principle of matching costs and revenues, and reached the following conclusions:

> TransCanada submitted that normalization achieves a better matching of costs and revenues and is recommended by the CICA. However, the CICA also allows for the use of the flow-through method by regulated companies. The evidence indicates that the flow-through method provides for the matching of costs and revenues for regulated companies. The Board is of the opinion that because rates are designed on the allowable cost of service, the matching principle and the CICA recommendations are a relatively neutral factor; in any year, revenues equal cost of service regardless of the method of tax accounting used.[3]

That finding appears equally applicable in the Westcoast application. It would also appear that the recognition given by the accounting profession, in the case of a regulated utility, to either flow-through or normalized income taxes as a cost in the period in which such taxes are recorded, is contingent upon the treatment given by the appropriate regulatory authority to that element of cost in setting the rates for that utility. As a result, such recognition of normalized taxes as a cost seems equally to be a neutral factor

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3. TransCanada PipeLines Limited, Phase I, June 1975, Page 4-5.

and to be of little assistance to the Board in this case in deciding whether Westcoast should be permitted to recover normalized income taxes in its cost of service.

With respect to the Company's proposal to recover past deferred taxes in its cost of service over the remaining term of Licence No. GL-41, the submission given in support of this largely turns upon the Company's position that the use of capital cost allowances in excess of booked depreciation is a cost as a matter of principle, which must be recovered as soon as possible in its cost of service. As a matter of practicability, Westcoast acknowledged that immediate recovery of the total past deferred income taxes was impossible, and thus proposed recovery of these taxes over the remaining term of the export licence. In the case of non-regulated companies, the CICA deals in its accounting recommendations with what a company should do with respect to past periods when changing from flow-through to normalized income tax accounting. In the non-regulated situation, the appropriate adjustments are made to a company's retained earnings and the appropriate deferred tax reserve is set up in the accounts. For the non-regulated company, the restatement of past years earnings has no effect upon current or future revenues. The CICA recommendations make no reference to what should be done in the case of regulated utilities in respect of past deferred

taxes on a conversion from flow-through to normalized tax accounting. More particularly, the CICA recommendations do not deal with the "catch-up" proposal put forward by Westcoast to recover past deferred taxes over a specific time period. Similarly, there would not appear to be any regulatory precedent in Canada which supports such a procedure.

2. The Likelihood of Crossover and the Need for Consistency

In the 1977 Interprovincial decision, the Board considered as a factor in its decision on whether to permit the recovery of normalized income taxes in Interprovincial's cost of service, the likelihood of crossover. The Board concluded in that case that the likelihood of crossover was not sufficiently uncertain to suggest the use of the flow-through method.[4]

The Board has noted the difference between the Interprovincial case and that of Westcoast. In the Interprovincial case, the Company has been accounting for income taxes on the normalized basis since its inception, and the issue facing the Board was whether the Company should continue on the normalized basis. On the other hand, Westcoast has used the flow-through method of tax accounting since 1957 and now seeks to change to the normalized method.

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4. Interprovincial Pipe Line Limited, Phase II, December 1977, page 4-37.

Westcoast provided its projection of capital additions to its utility plant for the years 1978 to 1988. For the years 1978 and 1979, the Company shows substantial capital additions in the amount of $309,439,000. In 1980, capital additions are forecast at $66,291,000. Thereafter, Westcoast forecasts capital investments in utility plant from 1981 to 1988 of some $20 million to $40 million per year, primarily in gathering and compressor facilities. The Company considers this forecast to be "fairly accurate" for the period ending in 1988. There are no capital additions forecast in the period after 1988.

On the flow-through basis of income tax accounting, the Company forecasts that it will pay income taxes of some $25 million in 1983 and $49 million in 1984, with continuing increases in each year in the period to 1995. It thus appears that, on the flow-through basis, the Company would reach crossover — that is, the point when capital cost allowances available for tax purposes no longer exceed booked depreciation — sometime in 1983 or 1984. If Westcoast were to change over now to the normalized method of tax accounting, it would reach crossover at some time earlier than 1983.

Several Intervenors questioned the capital development plans of Westcoast as being unduly conservative and short-term in nature. Reference was made to the evidence of Westcoast's policy witness, who indicated his expectation that the Company would continue to grow and be dynamic, and would have gas to deliver through its existing system for more than 26 years.

The Board has noted that included in Westcoast's capital expansion forecast for 1978 and 1979 is its proposal for the construction of mainline looping, having a capital cost of some $80,578,000. Since the forecast was prepared, the Company's application for a certificate under Part III of the NEB Act for the mainline looping was denied by the Board,[5] with the result that the capital forecast for 1978 and 1979 would be reduced to some $228,861,000. The effect of this reduction in the forecast capital expenditures would be to advance the date of crossover regardless of whether the Company is on the flow-through or normalized method of tax accounting.

The Board appreciates that any forecast of future capital expansion is subject to doubt, and that a forecast going beyond ten years is probably highly speculative. The Board accepts Westcoast's estimate of gathering plant additions for the next ten years as not being unreasonable,

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5. Westcoast Transmission Company Limited, June 1978.

although it is aware that the level of expenditure will depend upon the size and location of any new natural gas discoveries, and economic conditions at the time. As a result, the Board concludes that the occurrence of crossover is not sufficiently uncertain to warrant the continued use of the flow-through method of tax accounting for Westcoast.

3. Westcoast's Need for Funds Generated by Normalized Taxes and the Associated Benefits to the Company

In support of its application to change over to the normalized method of income tax accounting, Westcoast referred to its anticipated capital requirements for the expansion of its existing pipeline system and for investment in the Foothills Yukon Project. While the Company anticipated investing some $309 million in its existing pipeline system by the end of 1979, this has been reduced to some $229 million by reason of the denial of the mainline looping project. After 1979, the Company forecasts a lower level of capital expansion until the end of 1988. With respect to the Foothills Yukon Project, the Company anticipates a requirement to provide equity financing of some $350 million to $410 million.

Westcoast has acknowledged that this is not a "hardship" application and that the Company should be able to raise the capital necessary for the expansion of its

existing pipeline system and for the equity investment in the Foothills Yukon Project. It would appear to the Board that, to the extent Westcoast's need for capital is based upon its intended investments in the Foothills Yukon Project, such need is neither a relevant nor an appropriate consideration to be taken into account by the Board in determining the just and reasonable rates and tolls to be charged to the customers of the Company's existing pipeline system.

Associated with the Company's submission regarding its need for capital was the related argument that normalized income taxes, as a cost-free source of capital to Westcoast, would result in substantial financial benefits to the Company. It was also argued that, to the extent these benefits were obtained by Westcoast, there would be a consequent reduction in the cost of service to its customers. The financial benefits to Westcoast were stated to be among others a reduced need for external financing. The Board recognizes that, to the extent normalized income taxes provide an alternative source of capital to the Company, its need for external financing would be reduced for any given level of investment. As a result, the interest expense to be included in Westcoast's cost of service would be reduced proportionately, which would be of some benefit to the Company's customers.

4. <u>Intergenerational Equity - Current Normalized Income Taxes</u>

It was Westcoast's position that the recovery by it of current normalized income taxes and past deferred taxes in its cost of service, on the basis proposed by the Company, would tend to enhance the relative equities between various classes and generations of customers and producers.

In assessing Westcoast's submissions on the various equities associated with flow-through and normalized methods of tax accounting, it is necessary to keep in mind the circumstances in which Westcoast carries on its operations and in particular the existence of the BCPC Agreement which creates a unique situation for Westcoast as compared with other Federal pipeline companies.

The Company's submissions as to the relative equities may be summarized as follows:

(a) on the flow-through method of income tax accounting, present customers are receiving the benefit of postponing the payment of income taxes, the burden of which will fall upon future customer groups;

(b) with the expiration of the export licence in 1989, there will be a substantial change in the mix of customers and their rates of take, so that injustices will occur to the later customer groups in having to bear costs associated with services provided to earlier customer groups;

(c) with respect to out-of-province producers (Alberta and the Territories) who supply gas to meet the export commitment, any costs including income taxes which are not recovered from those producers by 1989, will fall upon the domestic customers of Westcoast after 1989;

(d) with respect to the major portion of the export gas, which is produced in British Columbia and purchased from the BCPC, the burden of taxes associated with providing the export service will fall upon domestic customers, if the revenue stream from exports does not bear the tax burden by 1989; and

(e) with the termination of the export licence in 1989, there will be a substantial decline in throughput in the Westcoast system (536 Bcf in 1989 to 289 Bcf in 1990), with the result that the proportionate burden of income taxes falling on the remaining customers of the system after 1989 will be substantially higher.

Considerable evidence was given in the course of the hearing to the relative effects of the two methods of income tax accounting upon the present and future cost of service of Westcoast. The difference between the two methods turns upon the different bases for calculating the income tax component of the cost of service. Under the normalized

method, the income tax expense included in the cost of service is determined using the booked depreciation recorded by a company. Under the flow-through method, the income tax expense is based on the level of capital cost allowances permitted for income tax purposes. Generally, in the earlier years of a company's existence, capital cost allowances exceed booked depreciation, whereas in the later years capital cost allowances are lower than booked depreciation after crossover. As shown in the cost of service projections filed by Westcoast, the flow-through method tends to provide for lower income taxes in the cost of service in the earlier years and higher income taxes in the later years in the period after crossover. Under the normalized method, the tax component is somewhat higher in the earlier years and lower in the later years as compared with the flow-through method.

While the normalized method tends to increase or "front-end load" the income tax burden in the earlier years, as compared with the flow-through method, the normalized method tends to provide for a greater stability in the overall cost of service in the future years. Several Intervenors submitted that the Board should, in assessing the relative merits of the two approaches, have regard to the discounted or present value of the two revenue streams resulting from the application of the two approaches. The

present value of the cash flow is less on the flow-through approach than that on the normalized approach. In the Interprovincial case, the Board rejected this approach as being a determining factor.[6] It appears to the Board that discounting the relative cash flows provides little insight into the relative equities of those cash flows over time.

Certain of the Intervenors supporting flow-through accounting, with its consequential higher tax levels in later years, suggested that, in viewing the cost of service in total, the increase in the tax component in the later years would be offset by a decline in the Company's rate base and thus in the level of return included in the cost of service. Under the cost of service, rate base, rate-of-return approach, there is a trend to a decline in the amount of the return in the later years as the rate base declines through depreciation. This trend, however, is offset by two other trends in the overall cost of service. Firstly, as shown by Westcoast's projections, there is a trend to increased operating and maintenance costs in the later years due to increased age of facilities and the effects of inflation. Secondly, in the later years of a company's existence, with reduced capital investment, there is a trend to the retirement of funded debt and a greater proportion of the capital structure being composed of equity. For any given level of return, the greater level of equity tends to

6. Interprovincial Pipe Line Limited, Phase II, December 1977, page 4-38.

increase the income taxes associated with that return.

It appears to the Board that the higher income tax burden in the later years associated with the flow-through method would not necessarily be offset by other trends in other components of the cost of service. In fact, the reverse situation could occur.

At this time, it is not known whether any portion of Westcoast's facilities will be used for export service beyond 1989; whether that occurs would depend upon the gas supply situation and other factors existing at that time. If no gas flows to export, the burden of income taxes deferred between now and 1989 would potentially fall upon the domestic customers of Westcoast, instead of upon the out-of-province producers and the BCPC.

With respect to the out-of-province producers who are supplying gas for the purposes of the export commitment, there is a possibility that these producers will cease supplying gas to Westcoast if the export licence is not renewed or extended in 1989. It may be, however, that these producers would continue to supply gas to Westcoast to meet its domestic demand after 1989, depending upon the deliverability of British Columbia gas at that time, although there is no certainty of this. There is also a risk, as pointed out by the Attorney General of British Columbia, that these producers would no longer be available after 1989 to share in the burden of flow-through taxes arising

from deferrals from prior years' operations. The risk associated with this possibility would fall on either the domestic customers or the BCPC. On the other hand, the Board sees no substantial inequity arising in the case of the out-of-province producers if they were to bear the burden of current normalized taxes between now and 1989.

Having regard to the above considerations, the Board is of the view that the inclusion of normalized income taxes on a current basis in Westcoast's cost of service, and the deduction from rate base of taxes collected but unpaid, would result in a greater degree of equity between the various classes of customers over time, and between the domestic customers and the out-of-province producers.

5. Intergenerational Equity - Prior Years' Deferred Income Taxes

From an equity viewpoint, the case in favour of Westcoast's proposal to recover past deferred income taxes over the period until 1989 is not as persuasive as that for current normalization. Westcoast acknowledges that its proposal to recover the past deferred income taxes over the period to 31 October 1989 would not result in recovery of those income taxes from precisely the same customers who obtained the benefits of past deferrals of income taxes, or from the same customers in the same proportion to the benefits previously obtained.

With respect to past deferred taxes related to domestic sales in the prior years, there would not appear to be any compelling reason from an equity viewpoint to place that burden upon the present customers of Westcoast as opposed to future customers under the flow-through method. Moreover, Westcoast's proposal to recover these taxes over the period to 1989 fails to take account of its own expectation that the Company will be serving the domestic customers for a considerable period after 1989.

With respect to the past deferred taxes arising from the export business of the Company in prior years, Westcoast has submitted that this burden would fall on the domestic customers of Westcoast after 1989 if it is not collected from the export revenues prior to that time. The major portion of the export gas is supplied by the BCPC, and it is likely that this agency or some successor to it will continue to perform the same or comparable functions after 1989. Since the burden could be absorbed by the BCPC under flow-through tax accounting after 1989, or under Westcoast's proposal before 1989, no strong equity argument in favour of one result or the other would seem to arise. After 1989, the burden could fall on the domestic customers but this is only one of several possibilities which could occur.

With respect to the out-of-province producers, it would appear that some inequity could arise after 1989, if the burden of past deferred taxes related to out-of-province gas supplied to the export market were to fall either on the domestic customers or the BCPC. However, Territories' producers which have supplied export gas would still use Westcoast's system to serve British Columbia markets if exports are terminated. In addition, Pan-Alberta Gas Ltd., which has been supplying a major portion of the Alberta gas exported under Licence No. GL-41 since 1974, did not obtain the benefits of the prior income tax deferrals related to export gas in the years prior to 1974. It does not appear to the Board that equity demands that the burden of these past deferrals be shifted to that company in the period to 1989.

The Board has also noted that Westcoast's argument in favour of the "catch-up" of past deferred taxes is somewhat inconsistent with the Company's position that normalization of income taxes generally operates to place the proper burden of costs upon the persons receiving the benefits of the Company's services.

6. Ability of Westcoast's Customers to Pay Increased Tolls Arising From the Proposed Change to Normalized Tax Accounting

In the course of the hearing, Westcoast filed a study illustrating the impact of its application upon its customers and upon the price of natural gas to the ultimate consumer in British Columbia. The study shows the relative

prices of natural gas, oil and electricity in the residential, commercial and industrial sectors of the British Columbia market, based on Westcoast's existing rates and tolls and on those proposed in its application. In preparing this exhibit, Westcoast took into account the 21 cents per Mcf increase, effective 1 March 1978, in the wholesale price of natural gas in British Columbia. However, it did not consider the one dollar increase in the wellhead price of Alberta crude oil which became effective 1 July 1978.

The conclusion reached in the Westcoast study was that, in the residential, commercial and small industrial sectors of the British Columbia market, natural gas would retain its competitive price advantage as against oil and electricity. In the large industrial sector, however, the effect of Westcoast's proposed tariff changes is generally to make oil and natural gas competitive in the Province, although this relationship could be altered somewhat by the 1 July 1978 increase in the wellhead oil price. In the B.C. Hydro service area the proposed increases would add to the existing price advantage of oil in the large industrial sector. However, Westcoast indicated that few, if any, of B.C. Hydro's customers purchase gas under that category.

B.C. Hydro disagreed with the assumptions used by Westcoast in its study as to the relative thermal efficiencies of oil, gas and electricity in the residential sector. In B.C. Hydro's study of residential annual heating costs, natural gas is shown to have an annual cost equal to 66 per cent of that of oil in the Lower Mainland and less than 50 per cent of the oil cost in the interior of the Province. The B.C. Hydro study shows a greater price advantage for natural gas in relation to electricity on an annual cost basis.

In the case of Inland, the effect of Westcoast's overall application would be to increase Inland's wholesale price of gas by some 30 cents per Mcf. Inland questioned the conclusions reached in the Westcoast study because they were based on electricity rates charged by B.C. Hydro. Some 40 per cent of Inland's service area is supplied with electricity by West Kootenay Light & Power Company Limited ("WKL&P"), which has lower electricity rates than B.C. Hydro. Based on the overall increase sought by Westcoast, Inland's evidence showed that natural gas and electricity would be competitive in price in the WKL&P service area, and that electricity would have a price advantage in the City of Kelowna. Inland expressed concern as to the risk of losing industrial customers as gas prices rise and of possible competition from wood wastes as an alternative energy source.

The forest industry has been experimenting with wood wastes as an alternative energy source, and although wood wastes cannot entirely replace fossil fuels, some pulp mills have now achieved up to 50 per cent self-sufficiency. The costs of wood wastes vary from mill to mill depending upon the source of supply and transportation costs. There are also substantial capital costs associated with the conversion to wood wastes as an energy source.

The forest industry accounts for some 20 per cent of the domestic gas market served by Westcoast. The witness appearing on behalf of the Council of Forest Industries of British Columbia indicated that the overall impact of Westcoast's application would be to increase the industry's gas costs by some \$8.3 million, of which approximately \$5.8 million would be incurred in the pulp and paper sector. The British Columbia forest industry has in recent years experienced a weak international market for plywood and pulp, although the paper market remains healthy. The international price of pulp has fallen from \$415 per ton in April 1977 to \$330 per ton in December 1977. The British Columbia pulp industry is also facing competition from South American and African pulp producers.

Some ten Mcf of gas are required to produce a ton of pulp, at a cost of \$14.50 at present prices. If Westcoast's application were completely successful, the gas

cost per ton of pulp could increase by $3.20, which is equivalent to less than one per cent of the international price of a ton of pulp. The COFI witness did not take the position that the overall increase sought by Westcoast would, of itself, make the British Columbia forest industry noncompetitive. He stated that an increase in natural gas prices, when taken in conjunction with other cost increases (raw materials, labour, supplies and transportation) could cause a problem for the industry. The major problem for the forest industry centres on the depressed condition of the world market.

The evidence given by Westcoast and the Intervenors was based on the effect of Westcoast's total application for changes in its rates and tolls, including not only the changes in depreciation and income taxes, but also in the return on rate base, other components of the cost of service, and in the design of the demand and commodity portions of its rates. In Phase I, the Board is only considering the depreciation and income tax components of the cost of service. It is the Board's view that the impact of any other proposed changes in the Company's rates and tolls should be considered in the later phases of the hearing together with the other evidence relating to those issues.

The increase in the depreciation component of the cost of service allowed by the Phase I Decision, excluding the accelerated depreciation of the portion of the main transmission plant allocated to exports in that Decision, amounts to $230,000. On the basis of the test year throughput of 404,310,133 Mcf, the resulting increase per Mcf is negligible. The Company's proposal to collect current normalized income taxes would add some $39,588,000 to the cost of service and result in an increase of 9.78 cents per Mcf.

Having considered the evidence, the Board finds that the inclusion of current normalized income taxes in Westcoast's cost of service would not have a significant impact upon the existing competitive position of natural gas relative to other energy sources in British Columbia.

7. Impact of Increased Tolls Due to Normalized Taxes upon Alberta Producers

Pan-Canadian Petroleum Limited submitted that the effect of Westcoast's proposal to recover current normalized income taxes and past deferred taxes in its cost of service would be to reduce the revenues to Alberta producers to the extent of some $8 million per year. It was submitted that a major shift of revenues from the producing sector to the transmission sector would result in reduced exploration and development of new energy supplies.

If Westcoast were only permitted to recover current normalized income taxes in its cost of service, the reduction in revenues to Alberta producers would be proportionately less. The burden of any reduction in the differential revenue related to gas moved to the export market over the Westcoast system would not fall on the particular Alberta producers supplying that gas. The reduction would in fact affect all Alberta producers by causing a reduction in the price adjustment paid by the Alberta Petroleum Marketing Commission.

In the Board's view, a reduction of this magnitude, when shared by all Alberta producers, would not have a significant impact upon the level of exploration and development being undertaken by those producers.

8. The Timeliness of a Change and the Risk of Future Collectibility of Income Tax

In the Board's view, there are several considerations which affect the issue of whether it is appropriate to permit Westcoast to change to the normalized method of income tax accounting and to recover current normalized income taxes in its cost of service. On the flow-through method of tax accounting, Westcoast's projections show that the Company will be required to pay substantial income taxes commencing in 1983. At present,

the export price of natural gas is considerably in excess of the costs of producing and transporting that gas for sale in the export market. The revenues from export sales after recovery of current normalized income taxes by Westcoast would still provide substantial revenue in excess of costs to both the BCPC and out-of-province producers. With respect to gas sold in the British Columbia market, the increase in Westcoast's cost of service related to current normalized income taxes, if the burden of it is passed on to the domestic distributors and the ultimate consumers, would not affect the competitive position of natural gas in the British Columbia market, and would not appear to place an undue burden on the ultimate consumer. In respect of out-of-province gas sold in the export market, the reduction in the price adjustment paid to Alberta producers would not appear to have any significant impact upon the level of exploration and development for new energy sources by those producers. In addition, the inclusion of current normalized income taxes in Westcoast's cost of service would appear to create a greater degree of equity between various groups of customers and producers.

There is always the risk, although unquantifiable, that in the future the price of natural gas would not be competitive with that of alternative energy sources. This could arise from technological change or from increased

costs associated with the development, recovery and transportation of new sources of natural gas. This risk exists whether Westcoast is recovering income taxes in its cost of service on either the normalized or the flow-through basis, although the risk is somewhat greater on the flow-through method, since the recovery of income taxes under that method occurs later in time than under the normalized method.

It was the submission of the BCPC that the BCPC Agreement provided a "unique assurance" to Westcoast that, if it remained on the flow-through basis, its income taxes would be recoverable in subsequent years as they became payable. It appears to the Board that, while the BCPC Agreement may offer some greater degree of assurance to Westcoast than the Company would otherwise have without that Agreement, the BCPC, as a sole supplier of natural gas and Westcoast as the sole transporter of that gas in British Columbia, are both at risk with respect to the future competitive position of natural gas. While it may be open to the BCPC to accept reduced revenues under the Agreement in order to permit Westcoast to recover its income taxes in the future, it does not follow necessarily that this will be the case or that it would ensure the competitive position of natural gas in future markets. As a result, the Board does not consider the existence of the BCPC Agreement as being a decisive factor against the recovery by the Company of normalized income taxes in its cost of service.

ALLOCATION AND ACCELERATED DEPRECIATION

As noted previously, the Phase I Decision suggested that, as a matter of principle, Westcoast's main transmission plant might be allocated between the export and domestic business of the Company. It also suggested that, with respect to the portion of the transmission plant allocated to the export portion of Westcoast's business, depreciation of the remaining cost of that plant might be recovered over the remaining life of Licence No. GL-41. These suggestions reflect the assumptions that the export licence will terminate in 1989 without renewal or extension and that, as a result, there would be substantial unused capacity in the Westcoast system thereafter.

As noted at page 2-10 of the Phase I Reasons for Decision, the Westcoast system was largely conceived and constructed to meet the requirements of the United States export markets, and additions were made to the main transmission plant primarily to meet increased export obligations. While it is not known at this time whether any portion of Westcoast's facilities will be used for exporting gas beyond 1989, the evidence is that domestic demand will continue to grow after 1989 and can be expected to require at least some portion of the pipeline capacity initially built to provide export service.

Furthermore, the Board in considering the evidence and the argument, including the submissions made on 26 July, concludes that matters to be considered at later phases of the hearing may well have a bearing on the question of allocation and accelerated depreciation.

DECISION

On the basis of the above considerations, it is the Board's view that it would be appropriate, in seeking to achieve just and reasonable tolls to be charged by Westcoast, to permit the Company to change to the normalized method of income tax accounting and to recover normalized income taxes on a current basis in its cost of service. In this respect, the Board would not vary the Phase I Decision.

In respect of Westcoast's proposal to provide for the "catch-up" of past deferred taxes in its cost of service in the period between now and 1989, the Board, in review, has not found the argument in favour of that proposal to be persuasive. Accordingly, the Board has concluded that it should vary the Phase I Decision by rescinding the decision to require Westcoast to recover past deferred taxes in its cost of service, in respect of exports over the remaining life of Licence No. GL-41 and in respect of domestic sales over a 25-year period.

The Board turns now to the concept raised in the Phase I Hearing and Decision, namely the allocation of depreciation, income taxes and plant as between the export and domestic business of Westcoast. It is the Board's decision that the question of allocation as between the export and domestic business of the Company should be left for further consideration and a final decision thereon in the succeeding phases of this Hearing.

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The above constitutes our Decision and Reasons for Decision on the Applications for review of the Phase I Decision in the Application by Westcoast Transmission Company Limited.

Jack G Stabback
Chairman

Member

Member

Member

Ottawa, Canada
November 1978